Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:CTR:HAR:TL-N-6341-99
CJSantaniello

date: DEC 3 1999

to: Chief, Examination Division
Connecticut-Rhode Island District
Attn: Revenue Agent Mike Stacchiotti, Group 1306, through Case Manager Pat McGovern

from: District Counsel, Connecticut-Rhode Island

ject: Large Case Advisory Opinion - [redacted]

THIS DOCUMENT INCLUDES CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE SERVICE, INCLUDING THE SUBJECT TAXPAYER. THIS DOCUMENT ALSO CONTAINS TAX RETURN INFORMATION SUBJECT TO THE PROVISIONS OF I.R.C. § 6103 AND ITS USE WITHIN THE SERVICE SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW IT.

We are responding to your December 1, 1999 facsimile transmission, in which you request legal advice regarding the timing of deductions for certain amounts paid under a contract with several banks to acquire unsecured line of credit. For the reasons set forth below, we believe that the $[redacted] paid by the taxpayer in [redacted] is not currently deductible because the taxpayer did not draw on the available funds in that year, but rather deductible upon the expiration of the applicable commitment period.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

Issue

Whether the taxpayer may currently deduct "loan commitment fees" incurred annually over the life of the contract period, as alleged by the taxpayer, or upon the expiration of the applicable commitment period, as maintained by the Service.

Facts

On [redacted], the taxpayer entered into a five-year credit agreement with a group of banks. Under this agreement, the taxpayer could borrow up to $[redacted] at any time through [redacted], with the option to increase the available line of credit by $[redacted] under certain conditions. As consideration, the taxpayer agreed to pay an annual fee based on the rating of its long-term debt securities by either Moody Investor Services, Inc. or Standard & Poor's Rating Service. In [redacted], the taxpayer paid a loan commitment fee of $[redacted].

The taxpayer has never drawn on the line of credit. In fact, the taxpayer maintains that it had no plans to use the line of credit when it entered into the agreement except in the event of a possible, but unknown contingency. The purpose of this credit arrangement is apparently to bolster the taxpayer's credit rating, which in turn enables it to borrow at a lower interest rate. Because the fee was allegedly incurred to reduce its current interest expenses, the taxpayer deducted the entire $[redacted] paid in [redacted] on its Form 1120 for that year.

Discussion

I.R.C. § 162(a)[1] provides for a deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. If an expenditure results in the creation of an asset having a useful life that extends beyond the close of the taxable year, such expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. Treas. Reg. § 1.461-(a)(2).

In Rev. Rul. 81-160, 1981-1 C.B. 312, the Service announced its position regarding the timing of deductions for loan commitment fees. In that ruling, the Service revoked its earlier position, announced in Rev. Rul. 56-136, 1956-1 C.B. 92, that loan commitment fees or standby charges are deductible under section 162 when paid or incurred, depending on the taxpayer's method of accounting.

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[1] All statutory section references are to the Internal Revenue Code in effect during the taxable year at issue.

Both Rev. Rul. 56-136 and 81-160 involved commitment fees incurred pursuant to a bona-fide sales agreement, under which funds were made available in stated amounts over a specified period. In revoking Rev. Rul. 56-136, the Service characterized the fee not as an interest charge or service charge, but rather a charge for the acquisition of a property right. From this, the Service concluded that such fees are not currently deductible when paid or incurred, but must be deducted ratably over the term of the loan to which they relate, provided the available funds are drawn during the year in which the deduction is taken. As stated in the ruling,

> [a] loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. See Rev. Rul. 75-172, 1975-1 C.B. 145, and Francis v. Commissioner, T.C. Memo. 1977-170. If the right is not exercised, the taxpayer may be entitled to a loss deduction under section 165 of the Code when the right expires. See Rev. Rul. 73-191, 1971-1 C.B. 77.

Rev. Rul. 81-160 at 313.

In this case, the taxpayer has never drawn upon the available funds. As noted above, it appears that the taxpayer's principal motive in entering into the loan agreement is to reduce its interest costs by virtue of its increased credit rating. Consequently, under Rev. Rul. 81-160, the taxpayer may deduct the annual commitment fee when its right to borrow under the agreement expires.

The taxpayer disagrees with the proposed adjustment, relying on Kroy (Europe) Limited v. United States, 27 F.3d 367 (9th Cir. 1994), rev'g 92-2 U.S.T.C. ¶ 50,611 (D. Ariz. 1992), rev'g 92-1 U.S.T.C. ¶ 50,146 (Bkcy. D. Ariz. 1992). In Kroy, the taxpayer decided to go private through a leveraged buyout. Because it did not have sufficient funds to repurchase its stock, the taxpayer borrowed $60.6 million from three banks to finance the stock redemption. To obtain the loans, the taxpayer paid various fees, totaling approximately $4 million, which it then amortized and deducted. On audit, the Service disallowed the deduction on the ground that they were incurred in connection with a stock redemption.

In reversing the bankruptcy court's decision in Kroy, the district court held that none of the fees are deductible under section 162(k) because they were incurred "in connection with the redemption of its stock." Kroy, 92-1 U.S.T.C. ¶ 50,146. The court further concluded that because the payments were for services rendered, they could not be considered interest.

On appeal, the Ninth Circuit reversed, holding that the payments were deductible as ordinary and necessary business expenses under section 162(a) under the "origin of the claim" test established by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963). According to the court, the borrowing and the stock redemption constituted two separate and independent transactions, and that section 162(k) did not apply to the former transaction. Kroy, 27 F.3d at 370. Accordingly, the court found that the fees were deductible under section 162(a).

The taxpayer's reliance on Kroy is misplaced. The sole issue in that case was the deductibility of the commitment fees, rather than the timing of the deductions. Consistent with that case, the Service is not contesting the deductibility of the loan commitment fees incurred by the taxpayer in this case. Instead, the Service maintains, relying on Rev. Rul. 81-160, that because the taxpayer did not draw on any of the available funds in that year, the expenditure is not deductible either currently or ratably over the life of the loan agreement. Under Rev. Rul. 81-160, the expense is deductible under section 165 when the commitment period expires.

Since there is no further action required by this office, we are closing our file in this matter. Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

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District Counsel

By: _____
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Attorney